FX Forecasts

Desjardins Economic Studies
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November 26, 2015

A busy end of year

HIGHLIGHTS

- The likelihood of a looming U.S. key interest rate hike rebounded as of the end of October. The change boosted the U.S. dollar against numerous currencies.
- The Canadian dollar should settle in below US$0.75 in the near term. This movement will mainly come from the broad appreciation by the greenback expected with the onset of monetary firming in the United States. The loonie's weakness could then persist for part of next year; however, the planets should gradually align to support a rise.
- The euro's current value already reflects expectations of European Central Bank action at its December 3 meeting. Some remarks from President Mario Draghi even suggest aggressive action, possibly pulling the euro down a little more by the end of 2015.
- Swiss National Bank leaders reiterated recently that they were prepared to step in to prevent further franc appreciation and were keeping a close watch on what other central banks are doing. The Swiss franc should be fairly stable against the euro over the next few months.

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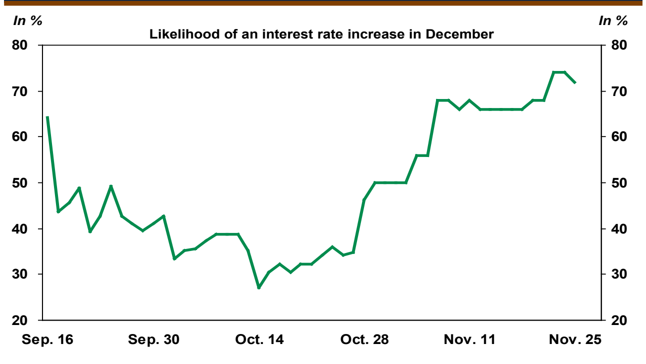
Editorial

The last few weeks have once again reminded us how quickly things can change. The likelihood of a looming U.S. key interest rate hike plunged in mid-September, then rebounded as of the end of October (graph 1). The change boosted the U.S. dollar against numerous currencies, especially against the euro, as the European Central Bank (ECB) opened the door to further monetary stimulus.

Graph 1 – The chances of a U.S. key rate increase have rebounded



Sources: Bloomberg and Desjardins, Economic Studies

The end of the year promises to be lively again for the currency markets. In particular, keep an eye on the ECB and Federal Reserve (Fed) monetary policy meetings, scheduled for December 3 and 16 respectively. Other events merit watching as well, such as the likely addition of the Chinese yuan to the International Monetary Fund's (IMF) special drawing rights basket. Lastly, price movements for oil and other commodities will continue to have a big influence on some currencies, including the Canadian dollar.

THE FED IS READY

The Fed has been signalling that it could raise its key rates by year-end for quite some time. September's inaction in an uncertain economic and financial climate had, however,

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prompted some analysts to push the onset of U.S. monetary firming back to 2016.

A string of events quickly changed the situation. Firstly, the Fed surprised the markets at its meeting at the end of October by leaving the door open for a December rate increase. One week later, the employment figures published in the United States gave this scenario quite a lot of credibility. The 271,000 jobs created in October contrasted sharply with the previous two months. To top it off, several Fed leaders made statements signalling a strong probability of firming in December. The publication of the October meeting's minutes confirmed these signals. In particular, the minutes indicated that most participants felt the economic conditions for raising interest rates would be in place by the next meeting.

THE MARKETS ARE READY

In September, the possibility of an interest rate increase in the United States had heightened concerns about the strength of the global economy. One fear was that a U.S. interest rate increase would prompt a flight of capital and currency depreciation in emerging nations, a situation that would aggravate what some were already calling a fragile situation. However, these fears have not surged in the last few weeks, despite the scenario shaping up for the Fed. Most emerging currencies have moved very little against the greenback. Some, such as the Brazilian real, have even appreciated.

The markets also seem to be approving of the Fed's plans. By raising its key rates, the Fed would prove that it has confidence in the U.S. economic recovery, thereby sending a positive signal. The stock markets had retreated after September's meeting, construing the Fed's inaction as a lack of confidence in the U.S. economy.

Reactions can still be expected if the Fed moves ahead on firming, if only because it is not yet 100% priced in. The currency market should once again see volatility. Expectations regarding monetary firming at upcoming meetings could go up, giving the greenback another push. The tone of the Fed's statement will also matter. Some expect the tone to be slightly cautious to temper any market reaction, but that might not be the case.

IS THE ECB STARTING ANOTHER CURRENCY WAR?

In terms of other events to watch that could generate volatility, the next ECB meeting seems especially important, and could even have greater repercussions than the Fed meeting. The ECB is not confident in inflation returning to its target over the medium range, and opened the door to further monetary easing. However, this happened in October, when the likelihood of a U.S. key rate increase seemed low and supported a euro above US$1.13.

The euro's value is one factor that influences inflation outlooks. Now that the Fed is gearing up for monetary firming in December and the euro is back at around US$1.06, there could be less pressure for ECB action. That being said, the remarks that most ECB leaders have made in recent weeks have not tried to cool expectations. The main question now for Euroland's monetary policy no longer seems to be whether or not the ECB will take action, but rather how aggressive that action will be. Will it simply postpone the estimated timeline for wrapping up its asset purchasing program, or will it opt for stronger measures, such as accelerating the pace of its purchases or cutting interest rates? In both cases, the ECB's decision could set off a chain reaction among Europe's other central banks, which will want to avoid seeing their currencies appreciate too sharply against the euro.

Depreciation by European currencies would magnify the greenback's gains in the short term. Over the longer term, however, we think there is a limit on the greenback's potential for appreciation.[1] The currency's strength does not seem to be without consequences for the U.S. economy and the Fed could play its own role in the currency war by moderating its future interest rate increases.

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[1] Desjardins, Economic Studies, *Economic News*, "Thoughts on the U.S. dollar's strength," November 16, 2015, www.desjardins.com/ressources/pdf/nf151116-e.pdf?resVer=1447687132000.

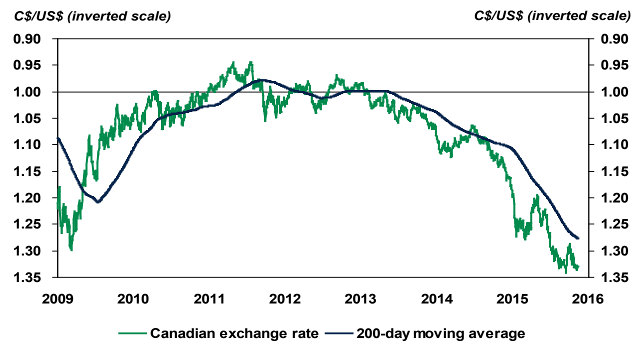
CANADIAN DOLLAR (CAD)

The incursions below US$0.75 are adding up

- The Canadian dollar has been back on a downward trajectory for just over a month. In the last two weeks, it has neared US$0.75 (C$1.33/US$), and made a few incursions below this symbolic level. The new period of loonie weakness comes in tandem with a U.S. dollar rebound prompted by the stronger likelihood of an interest rate increase in the United States. Oil prices have dropped to around US$40/barrel, another factor in the loonie's disfavour.
- Technically, the Canadian dollar's trend, measured using a 200-day moving average, is starting to show a softer slope, but it is still very negative, suggesting it will not turn around for several more months. The momentum calculated over three months barely increases and speculators continue to favour short positions in the currency. Nonetheless, the balance of speculative positions is less negative, possibly meaning that the market thinks the Canadian dollar is closing in on a low.
- Fundamentally, the drop in oil prices is overshadowing other factors that are more in the loonie's favour. The latest economic data confirms that real GDP will rebound in the third quarter following the technical recession recorded in the first half of the year. 2015 should end with a 1.1% advance, and growth is forecast to accelerate to 2.1% next year. The rebound is heavily based on growth by international trade and therefore on the Canadian dollar's weakness and solid advance by international demand, especially U.S. demand.
- Canada's monetary policy is now creating less currency volatility. The Bank of Canada had downgraded its economic outlook in October, triggering some movement, but that did not substantially alter the expectations for a key rate change. The Canadian economy's recent improvement and underlying inflation rate, which is holding above 2%, do not argue for another cut to the cost of money.

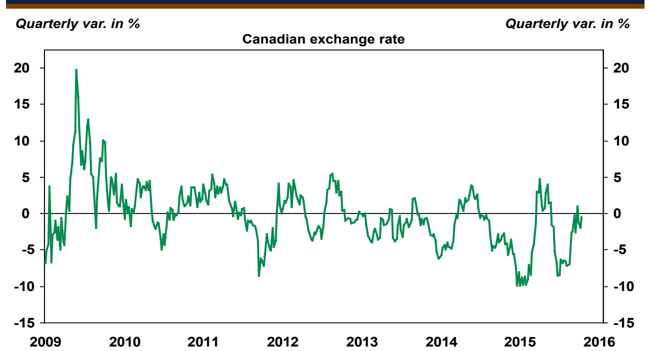
Forecasts: The Canadian dollar should settle in below US$0.75 (above C$1.33/US$) in the near term. This movement will mainly come from the broad appreciation by the greenback expected with the onset of monetary firming in the United States. The loonie's weakness could then persist for part of next year; however, the planets should gradually align to support a rise. This scenario relies on oil prices climbing to around US$60 a barrel by the end of next year.

Canadian dollar and trend



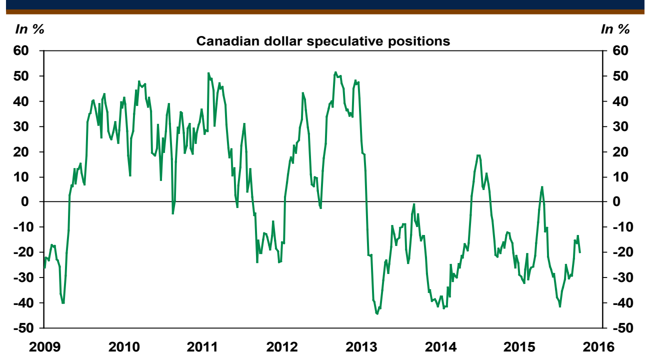
Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

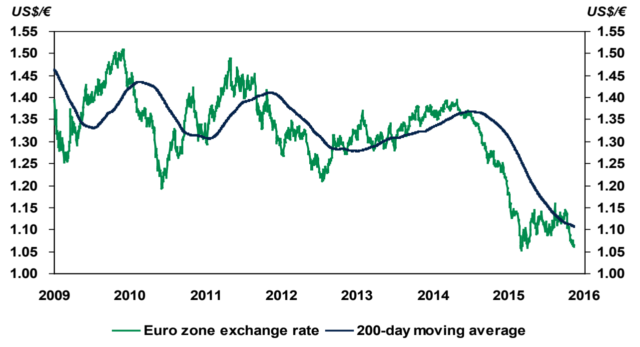
EURO (EUR)

Despite the euro's pullback, the European Central Bank will probably take action in December

- The euro's pullback, which started on October 22 when the European Central Bank (ECB) signalled that it was seriously contemplating further monetary stimulus, continued in recent weeks. The likelihood that U.S. key rates will go up in December has increased substantially, favouring greenback appreciation as well. The euro therefore recently slid to around US\$1.06, off more than 7% from where it was in mid-October.
- Unlike what happened at the end of the summer, when key rate increases were put off in the United States, favouring the euro, the euro's recent retreat reflects heightened expectations of monetary policy divergence between the United States and the euro zone. Statements by monetary authorities on either side of the Atlantic clearly justify this expectation, as Federal Reserve leaders are signalling they are ready to kick off monetary firming, while ECB leaders are getting ready to announce further stimulus measures.
- The euro zone's economy still seems to be moving in line with the ECB's modest expectations, with real GDP growth slowing a little in the third quarter to an annualized 1.2%. However, the ECB thinks that the downside risks have risen in recent months, as the outlook for global demand has worsened, especially in emerging markets. In this context, persisting weak inflation is worrying ECB leaders; in October, they noted that the drop in energy prices and the strong euro could bring on another downgrade to the inflation outlook. Commodity prices have continued retreating in the last few weeks, but the euro's big pullback could have reassured the ECB. However, ECB leaders know that this favourable development largely reflects expectations for monetary easing in December; it could thus reverse rapidly in the event of a status quo. The greater uncertainty following the Paris attacks is one more reason for the ECB not to let the markets down.

Forecasts: The euro's current value already reflects expectations of ECB action at its December 3 meeting. Some remarks from President Mario Draghi even suggest aggressive action. The ECB could therefore increase its quantitative purchases and take its deposit rate further into negative territory, possibly pulling the euro down a little more.

Euro and trend



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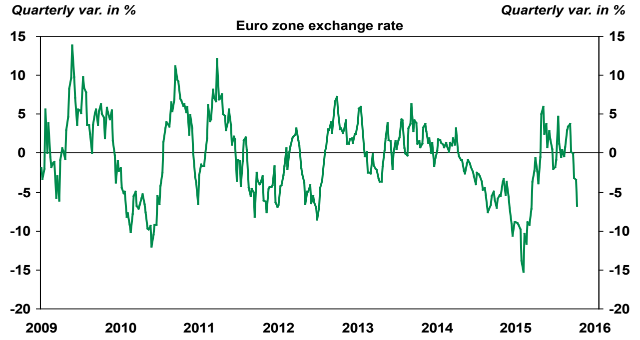
Euro: momentum



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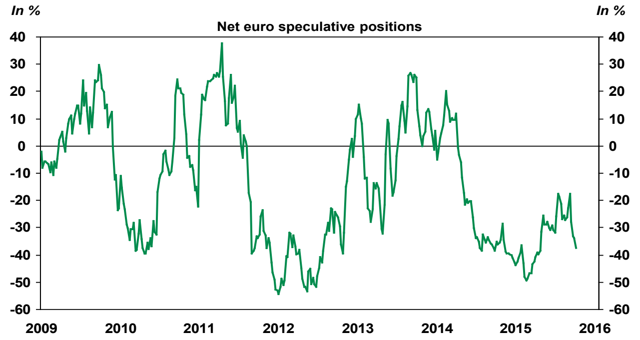
Euro: net speculative positions



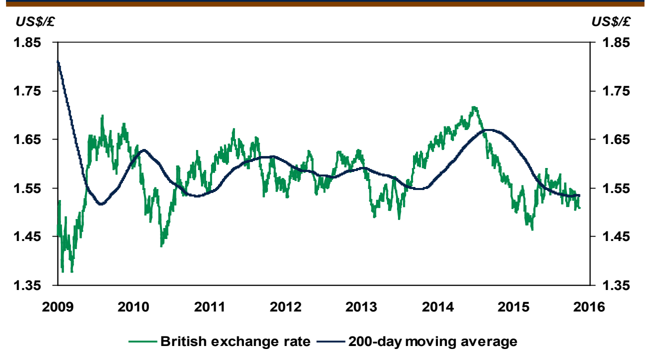
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

The Bank of England could move faster than the market expects

- Like most currencies, the pound has generally retreated against the U.S. dollar in the last few weeks. The Federal Reserve's status quo and the less favourable global economic environment have prompted investors to push a first increase to British key rates back to the fourth quarter of 2016. The pound closed in on US$1.50 in early November following the release of excellent U.S. labour market data. The pound has however appreciated sharply against the euro, with the EUR/GBP pair back at around £0.70, primarily reflecting the stronger expectations for monetary easing in the euro zone. Britain's real GDP growth slowed somewhat in the third quarter, settling at an annualized 2.0%. However, the outlook is still relatively favourable, and the labour market did well in September, with the unemployment rate down and accelerated hiring. The Bank of England (BoE) is therefore in a much different situation from the European Central Bank. **The BoE will opt for the status quo in the near term, but we still think that monetary firming could start somewhere around mid-2016. This could favour some appreciation of the pound against the euro and dollar.**

British pound and trend



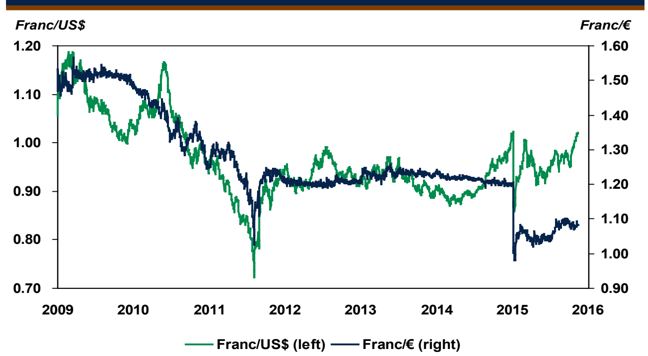
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

Will the Swiss National Bank determination continue to be enough?

- The USD/CHF pair recently hit 1.02 francs, a height not seen since the Swiss National Bank (SNB) abandoned its floor rate in January 2015. The franc has been very stable against the euro in the last few weeks, with the EUR/CHF pair staying around 1.085 francs. The franc's stability against the euro reflects the SNB's determination to prevent further franc appreciation in a context in which economic growth is weak and the inflation rate was stable at -1.4% in October. SNB leaders reiterated recently that they were prepared to step in to prevent further franc appreciation and were keeping a close watch on what other central banks are doing. In addition to acting directly in the currency markets, the SNB could take its key rates lower. **The Swiss franc should be fairly stable against the euro over the next few months.**

Swiss franc



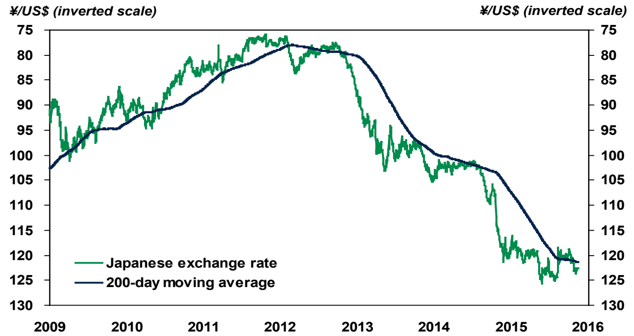
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

The Bank of Japan is not flinching in the face of the real GDP pullback

- The third-quarter 0.8% real GDP contraction (annualized) confirmed another technical recession in Japan. Despite this, the Bank of Japan (BoJ) did not change its stance at its November 18 monetary policy meeting. The vote was also the same, with one leader still favouring a cut to the asset purchasing program. Note, however, that the third quarter GDP contraction was mainly due to a major drop in business inventories. Both consumer spending and foreign trade advanced, some reassuring news for the future.
- The yen edged up after the November monetary policy meeting, as the chances of the BoJ announcing further stimulus measures now look slight. That being said, inflation has barely accelerated; this does not suggest that the BoJ can take its foot off the gas. The BoJ's balance sheet should therefore keep expanding over the next year, and perhaps in 2017, thus arguing for ongoing yen depreciation. **The exchange rate should settle in above ¥125/US$ in the months to come.**

Yen and trend



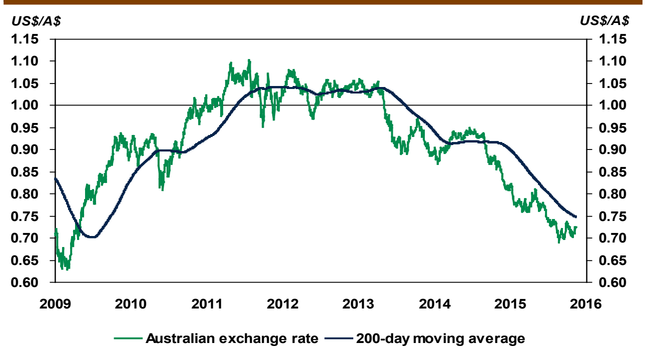
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The Reserve Bank of Australia is a little more optimistic

- The exchange rate is holding between US$0.70 and US$0.72, with a slight bias to the upside seen recently. The main factors affecting the aussie remain the Chinese economy's movement, commodity prices, and monetary policy expectations. While the Chinese economic situation remains worrisome, the concern is not as strong now as it was a few months ago. Thereafter, several commodity prices are tending to stabilize. Lastly, the Reserve Bank of Australia (RBA) seems to be in less of a hurry to announce additional stimulus as the economy is showing encouraging signs, especially in employment.
- The Australian dollar's recent trend is still fragile, as fears over China could notch up and the RBA could have to adjust its stance in the next few months. The monetary authorities are also concerned about weak inflation. The currency's depreciation did not have as big an impact as anticipated on price levels. **The Australian dollar could drop back below US$0.70 in the months to come.**

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

Little panic in the run-up to probable U.S. monetary firming

CHINESE YUAN (CNY)

- China's exchange rate is more volatile as the Chinese authorities no longer want to see the yuan rise in tandem with the greenback. The yuan has depreciated a little in the last few weeks on the greater likelihood of U.S. monetary firming. **The exchange rate is in the neighbourhood of 6.40 yuan/US$ and should close in on 6.45 yuan/US$ by year's end.** The probability of the International Monetary Fund (IMF) adding the yuan to its special drawing rights basket seems high. This may increase use of the yuan as a reserve currency, something that could give it some support. However, use of the yuan as a reserve currency will be more dependent on reforms to China's financial system, particularly the availability of low-risk securities in which foreign currency reserves are primarily invested.

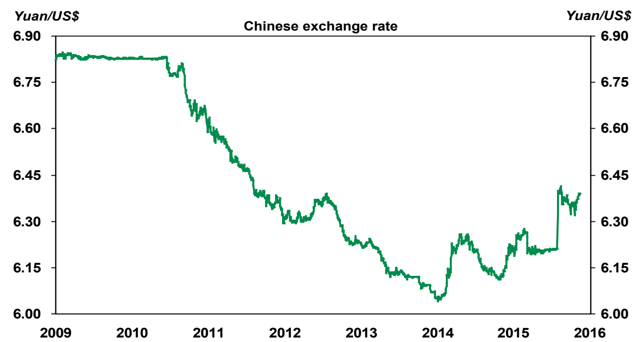
MEXICAN PESO (MXN)

- Unlike what we saw last summer, the potential onset of U.S. monetary firming in December is not having much negative impact on the Mexican peso. After ticking up at the start of the month, the USD/MXN pair recently returned to around 16.50 pesos. Encouraging Mexican economic numbers, including Q3 real GDP growth of 3% and stronger industrial output, are also responsible for the peso's resilience. If additional downside pressure on the peso were to materialize suddenly, the Bank of Mexico would seriously contemplate raising its key rates. Hasty action does not seem necessary right now, however, as inflation remains very low. **The peso should be fairly stable in the near term, then start to rise next year.**

BRAZILIAN REAL (BRL)

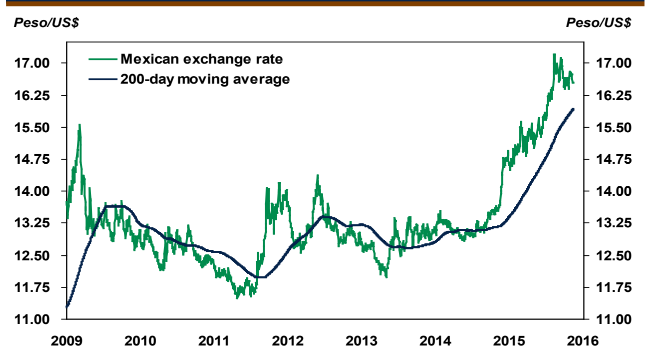
- Brazil's real recently appreciated against the greenback. It had plunged in the last few months due to the weak Brazilian economy and allegations of corruption against a number of national leaders. Central Bank of Brazil (CBB) action in the currency swap market helped calm the situation down. The CBB is also trying to help the economy by moderating key rate increases, despite high inflation. The hoped for economic rebound could make the real appreciate and reduce the inflationary pressure generated by currency movements. **We still remain negative on the real, which could return to the 4 real/US$ mark in the near future.**

Chinese yuan and trend



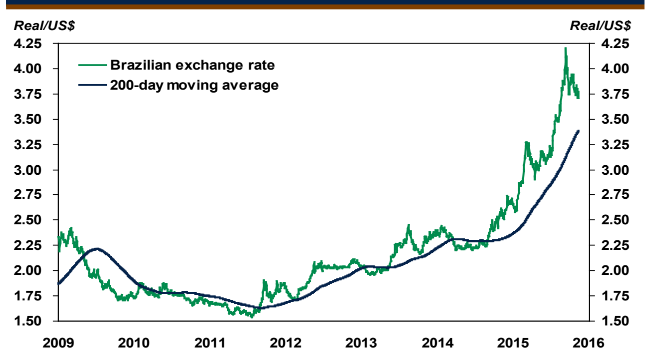
Sources: Datastream and Desjardins, Economic Studies

Mexican peso and trend



Sources: Datastream and Desjardins, Economic Studies

Brazilian real and trend



Sources: Datastream and Desjardins, Economic Studies

Table 1
Currency market

Country – Currency*	Spot price Nov. 25	Percentage return since 1 month	3 months	6 months	1 year	Last 52 weeks Higher	Average	Lower
Americas								
Argentina – peso	9.6767	1.6572	4.3777	7.8791	13.6291	9.6767	9.0073	8.4645
Brazil – real	3.7709	-2.8807	6.6703	23.0514	48.7485	4.2061	3.2120	2.5038
Canada – dollar	1.3314	1.2164	0.2485	8.3672	18.3204	1.3411	1.2570	1.1234
Canada – (CAD/USD)	0.7511	-1.2017	-0.2479	-7.7212	-15.4837	0.8902	0.7955	0.7457
Mexico – peso	16.5714	0.3567	-2.3548	8.4345	21.5380	17.1993	15.6124	13.6348
Asia and South Pacific								
Australia – (AUD/USD)	0.7252	0.5076	1.7259	-7.3241	-14.9964	0.8547	0.7608	0.6908
China – yuan renminbi	6.3892	0.6324	-0.3696	3.0184	4.1180	6.4129	6.2581	6.1365
Hong Kong – dollar	7.7505	0.0058	-0.0155	-0.0187	-0.0522	7.7708	7.7529	7.7499
India – rupee	66.3680	2.2738	0.1320	4.5231	7.2788	66.8855	63.7416	61.3580
Japan – yen	122.7200	1.0332	3.2301	0.9543	4.0220	125.6250	120.7923	116.1650
New Zeland – (NZD/USD)	0.6579	-2.5919	1.6249	-10.0059	-15.7819	0.7873	0.7072	0.6260
South Korea – won	1,143	1.6582	-4.3622	4.8849	3.0741	1,204	1,125	1,069
Europe								
Denmark – krona	7.0214	3.7088	8.3299	3.3684	17.7277	7.1086	6.6381	5.9484
Euro zone – (EUR/USD)	1.0602	-3.9021	-7.0897	-3.8236	-15.0854	1.2529	1.1251	1.0522
Norway – kroner	8.6418	3.0380	5.0381	13.0586	27.0012	8.6955	7.9227	6.8045
Russia – ruble	65.6350	5.7823	-5.0106	31.5463	43.2594	72.4500	59.8398	45.8155
Sweden – krona	8.7280	2.6709	4.2890	3.7029	17.5458	8.8229	8.3410	7.3973
Switzerland – swiss franc	1.0239	4.8597	8.0011	8.6025	6.2526	1.0239	0.9606	0.8533
United Kingdom – (GBP/USD)	1.5071	-1.8176	-3.9758	-2.7834	-4.1590	1.5884	1.5349	1.4642

* In comparison with the U.S. dollar, unless otherwise indicated.
Note: Currency table base on previous day closure.

Table 2
Currency market: history and forecasts

End of period		2014 Q3	2014 Q4	2015 Q1	2015 Q2	2015 Q3	2015 Q4f	2016 Q1f	2016 Q2f	2016 Q3f	2016 Q4f
American dollar											
Canadian dollar	(USD/CAD)	1.1199	1.1621	1.2688	1.2493	1.3315	1.3514	1.3514	1.3333	1.3158	1.2987
Euro	(EUR/USD)	1.2632	1.2101	1.0740	1.1142	1.1162	1.0600	1.0500	1.0600	1.0700	1.0900
British pound	(GBP/USD)	1.6212	1.5593	1.4845	1.5727	1.5148	1.5100	1.5100	1.5300	1.5500	1.5700
Swiss franc	(USD/CHF)	0.9534	0.9894	0.9744	0.9314	0.9734	1.0200	1.0300	1.0200	1.0200	1.0100
Yen	(USD/JPY)	109.66	119.70	120.14	122.50	119.87	123.00	125.00	125.00	126.00	127.00
Australian dollar	(AUD/USD)	0.8746	0.8170	0.7607	0.7709	0.7020	0.7100	0.7000	0.7000	0.7200	0.7400
Chinese yuan	(USD/CNY)	6.1385	6.2061	6.1995	6.2010	6.3571	6.4500	6.5000	6.5000	6.4500	6.4000
Mexican peso	(USD/MXN)	13.43	14.75	15.26	15.74	16.92	16.60	16.80	16.50	16.25	16.00
Brazilian real	(USD/BRL)	2.4507	2.6559	3.2077	3.1022	3.9725	3.8500	4.1000	3.9000	3.8000	3.6000
Effective dollar*	(1973 = 100)	81.30	85.13	92.06	89.94	92.26	94.90	95.60	94.90	94.10	93.00
Canadian dollar											
American dollar	(CAD/USD)	0.8929	0.8605	0.7882	0.8004	0.7510	0.7400	0.7400	0.7500	0.7600	0.7700
Euro	(EUR/CAD)	1.4147	1.4061	1.3626	1.3920	1.4863	1.4324	1.4189	1.4133	1.4079	1.4156
British pound	(GBP/CAD)	1.8155	1.8119	1.8835	1.9648	2.0169	2.0405	2.0405	2.0400	2.0395	2.0390
Swiss franc	(CAD/CHF)	0.8513	0.8514	0.7680	0.7455	0.7311	0.7548	0.7622	0.7650	0.7752	0.7777
Yen	(CAD/JPY)	97.91	103.00	94.69	98.05	90.02	91.02	92.50	93.75	95.76	97.79
Australian dollar	(AUD/CAD)	0.9795	0.9494	0.9651	0.9630	0.9346	0.9595	0.9459	0.9333	0.9474	0.9610
Chinese yuan	(CAD/CNY)	5.4813	5.3406	4.8863	4.9636	4.7744	4.7730	4.8100	4.8750	4.9020	4.9280
Mexican peso	(CAD/MXN)	11.99	12.69	12.03	12.60	12.71	12.28	12.43	12.38	12.35	12.32
Brazilian real	(CAD/BRL)	2.1883	2.2855	2.5282	2.4832	2.9835	2.8490	3.0340	2.9250	2.8880	2.7720

f: forecasts; * Trade-weighted against major U.S. partners.
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies